A STUDY ON THE SHORT TERM LENDING TO ENTREPRENEURS BY THE KERALA FINANCIAL CORPORATION IN THE FIRST TWO YEARS OF 12TH FIVE YEAR PLAN PERIOD

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ABSTRACT

The purpose of this study is to analyse the credit appraisal methodology adopted at Kerala Financial Corporation with special reference to the method adopted while providing working capital assistance. A detailed analysis is carried out of the steps followed by the Corporation while granting working capital loans to two units, one each from manufacturing and service sectors under two different schemes available out of the many schemes available at KFC for meeting the working capital needs of a unit. The findings of this paper show that the different financial parameters and their benchmark values which are required to determine the creditworthiness of borrowers especially of those availing working capital loans depends on the type of the sector of the economy to which it belongs. The credit appraisal method followed by any financial institution can thus be modified to suit the sector of functioning. The study contributes to the literature that the nature of the business influences the working capital requirement and management policies of any firm.

Keywords: Credit Appraisal Methodology, Working Capital, Sectors of Economy, Financial Parameters and Benchmark Values.

I. INTRODUCTION

SMEs are one of the major contributors to the socio-economic development of a nation being major sources of employment and export opportunities. SMEs provide large employment opportunities at comparatively lower cost of capital than large industries and also contribute to the industrialization of rural areas. The SME sector in India consisting of 36 million units producing more than 6000 products ranging from traditional to high-tech items, provides employment to over 80 million persons. The sector contributes about 8% to GDP, 45% to the total manufacturing output and 40% to the exports from the country (SME Chamber of India, 2014) [7]. Adequate and timely financing of SMEs is one of the critical factors which will help achieve the potential of SMEs of being a major partner in the process of inclusive growth through their innovative approaches in their operations.

1.1. Introduction to the Industry

The Industrial Finance Corporation of India (IFCI) was established by the government as the first Development

Financial Institution in the country, on July 1, 1948 with the objective to cater to the long-term finance needs of the industrial sector at the time of independence when India's capital market was relatively under-developed due to dearth of merchant bankers and underwriting firms and commercial banks not being equipped to provide long-term industrial finance in any significant manner. The DFI was provided access to low-cost funds through the RBI's Statutory Liquidity Ratio or SLR which enabled it to provide loans and advances to corporate borrowers at concessional rates. Following the liberalization in the early 1990s, the constitution of IFCI was changed in 1993 from a statutory corporation to a company under the Indian Companies Act, 1956 to meet the need to respond to the changing financial system with greater flexibility. IFCI could thus also directly access the capital markets for its funds needs.

Following the establishment of the IFCI in the year 1948, the State Governments expressed their desire to set up similar Corporations in States to supplement the work of the Industrial Finance Corporation by confining their activities to financing medium and small scale industries at the State-level and which are outside the scope of the Industrial Finance Corporation. The State Corporations were thus established under a special Statute, the State Financial Corporations Act, 1951. The SFCs provide assistance in the form of term loans, by underwriting issues of shares and debentures, by subscribing to debentures, and by standing guarantee for loans raised by the client from other institutions and from the general public. The SFCs thus serve the multiple national objectives of rapid industrial growth, balanced regional development, self-reliance, employment generation, and equitable distribution of income and means of production (Verma, 2010) [9].

1.2. About Kerala Financial Corporation

Kerala Financial Corporation (KFC) incorporated under the State Financial Corporations Act of 1951, was established as the Travancore Cochin Financial Corporation on 01.12.1953. Consequent to the formation of the Kerala State in November 1956 following the reorganization of states on linguistic basis, the Travancore Cochin Financial Corporation was renamed as Kerala Financial Corporation in 1956.

The functions of the Corporation are controlled and guided by the provisions of SFCs Act 1951 as amended in 2000. The main objective of KFC is the rapid industrialization of the state by extending financial assistance to Micro, Small and Medium Enterprises in manufacturing and service sector through formulation of suitable loan schemes. It provides financial assistance to the customers for setting up of new units and for the expansion / modernization / diversification of existing units in both manufacturing and service sectors, through a wide range of products and services.

Apart from term loans, the Corporation also provides Working Capital finance and Short Term Finance to the needy enterprises. It has devised innovative schemes such as modernization schemes for SSIs, Special schemes for Resorts, Hospitals, TV Serial Production, etc.

1.3. Problem Definition

The prime input for the sustained growth of small scale sector is credit. Credit required for any business is of long term and short term nature. Long term credit is needed for creation of fixed assets like land, building, plant and machinery. Short term credit is needed to meet the day to day requirement of purchasing raw material and other inputs like electricity, water, etc. and for payment of wages and salaries (Nayak, 2004) [5].

The major source of SME financing is external funding from commercial banks as primary lenders as against equity finance which is costly and inefficient due to the equity market of small firms not being well developed and most managers or owners lacking experience in this area. Thus any lack of efficient bank lending would deter the development of SMEs (Gama & Geraldes, 2012) [2]. Financial assistance must be provided by financial institutions to small units on easy terms and with hassle-free procedures through devising appropriate new schemes and implementing them (Nayak, 2004) [5].

The risk related to non repayment of credit by the customer of a financial institution is called ***credit risk***. Risk is inability or unwillingness of borrower to meet their repayment obligations as per the stipulated terms. Therefore in order to mitigate the credit risk, it is essential to appraise the credibility of the customer with respect to their financial condition and the ability to repay back the loan in future. This process to ascertain risks associated with the extension of the credit facility is called credit appraisal (Arora, Gaur, & Babita, 2013) [1].

In this paper, the Credit Risk Assessment Model of KFC is studied with reference to the method adopted to test the financial viability of the projects seeking working capital assistance under its various schemes. KFC offers a number of loan schemes of working capital assistance to industrial units both in the manufacturing and service sectors such as "Working Capital Revolving Fund Loan (WCTL)", "Special Working Capital Assistance to Hotels" as short term loans and "Working Capital Term Loan" as a long term loan. An attempt has been made to determine sector specific parameters and their benchmark values which can be utilised to carry out financial appraisal of projects applying for loans under different schemes.

II. LITERATURE REVIEW

Availability of working capital assistance is one of the major stimuli for improving the performance of any business. ***Working capital*** is the total amount of funds required for day to day operation of a unit. The amount of working capital required for a firm depends upon its ***nature of business***, such as manufacturing or service, among various other factors. Determination of appropriate amount of working capital of a SME unit and its funding would contribute to the growth of the firm.

Normally, manufacturing industries and trading organizations need more working capital than those in the service business organizations since a service sector unit requires minimum amount of stock of goods and also since there are less credit transactions in a service unit as compared to a manufacturing or trading firm.

2.1 Credit Appraisal Process

The primary task of any lender before granting financial assistance is to identify the risk factors and mitigate them on a continuous basis such that the risks do not deter the financial institution from lending. The success factors behind any business are managerial ability, favourable business environment, favourable industrial environment and adequate financial strength.

The ***Credit Risk Assessment models*** adopted by a financial institute take into account all possible factors which go into appraising the risks associated with a loan. They are categorized broadly into financial, business, industrial & management risks and are rated separately. The assessment of financial risk is carried out by appraisal of the financial strength of the borrower based on performance & financial indicators. The overall financial risk is assessed in terms of static ratios, future prospects & risk mitigation (collateral security / financial

standing). The common parameters used to rate the management of an enterprise / group are Integrity (corporate governance), Track record, Managerial competence / commitment, Expertise, Structure & systems, Experience in the industry, Credibility: ability to meet sales projections and profit projections, Payment record, Strategic initiatives and Length of relationship with the financial institution.

2.2 Working Capital Financing

Working capital refers to ***net working capital*** which is the excess of current assets over current liabilities. Current assets include cash, debtors, inventories which in the course of business can be converted into cash within a short period of normally one accounting period. Current liabilities include bank overdraft, bills payable, sundry creditors which are intended to be paid in the ordinary course of business within a short period of normally one accounting period, out of the current assets or the income of the business. The portion of the current assets not financed by current liabilities is known as ***working capital gap***. The working capital gap would be financed either by own source or from borrowings. Thus, working capital is financed by contribution from long term sources, which is known as net working capital and bank finance (Naik, 2014) [4]. Working capital is important because lack of working capital may lead the business to technical insolvency and ultimately to liquidation.

The Reserve Bank of India prescribes the norms to be used by banks for financing working capital requirements of a firm from time to time. The methods which are commonly used at the present time are Maximum Permissible Bank Finance (Methods MPBF – I and II), Turnover Method and Cash Budget Method (Naik, 2014) [4].

According to Moyer et al., 2003 (Moyer, McGuigan, Rao, & Kretlow, 2003) [3], there is no single optimal working capital policy which can be applied on all firms because the presence of industry or sector specific characteristics have an impact on firm's decision on the level of investment in working capital (Raheman, Qayyum, Afza, & Bodla, 2010) [6]. Thus, it can be concluded that the parameters which are used to determine the credit worthiness of the firm, especially ratios, would have different benchmark values for firms of different sectors or totally different parameters can be used for evaluation purpose.

III. DATA COLLECTION AND ANALYSIS

The objective of research paper is to study the Credit Risk Assessment Model of KFC adopted to disburse working capital loans through study on the commercial, financial & technical viability of the projects funded in the years 2012 and 2013. The industrial units studied were M/s. ABC Wood Industries, a wood manufacturing and processing unit from the manufacturing sector and M/s. Hotel DEF from the service sector. M/s. ABC Wood Industries was granted a working capital loan of Rs. 375.00 lakhs in the month of August, 2013 under the "Working Capital Revolving Fund Loan" scheme. M/s. Hotel DEF was granted a working capital loan of Rs. 50 lakhs in the month of February, 2012 under the "Special Working Capital Assistance to Hotels" scheme.

3.1 Principles of Lending and Loan Policy of KFC

The basic business objective of the Corporation, as stated in the Loan Policy document of KFC, is term lending to industries, to support sustained industrial growth in the State with special attention to the MSME sector. The

policy document which is reviewed annually is used by credit dispensing functions to create a good loan portfolio. The policy provides explicit guidelines to the concerned in the areas of project acceptance, appraisals and loan sanctioning. One of the major business lines of the Corporation is providing working capital loans. The sectors eligible for Corporation's support include among many others, the manufacturing sector which includes under its purview all manufacturing activities including processing and preservation; and hospitality sector (a kind of service sector) like hotels, lodges, restaurants, convention centre / seminar halls, tourist resorts, amusement parks, etc., as the need for this sector is being increasingly felt as a promotional support for state industrial / business growth. Simplified processes, quick credit decision and timely credit delivery is the thrust area of the Corporation for the benefit of the MSME customers.

KFC utilises agency services of CRISIL for credit rating. The Basel II regulatory framework for the banking sector aligns regulations with best practices for credit risk management and provides banks with an incentive to invest in more sophisticated risk measurement and management capabilities. It consists of three pillars: minimum capital requirements (credit risk, operational risk, and market risk), supervisory review process, and market discipline (Gama & Geraldes, 2012) [2]. An internal rating format has been developed for sanction and subsequent credit rating in respect of all cases. The credit rating is carried out on annual basis for all loans in respect of existing/new clients and they should obtain a score of 70 and above in the new credit rating continuum. The account with internal credit rating of 70 would be in the standard category and will be eligible for 0.5% reduction in interest rate.

The benchmark financial norms included in the appraisal note at the time of sanction of the units studied were:-

- DER (For the company as a whole, including proposed assistance) – 2:1, with the extent of relaxation permissible up to 3:1 for Micro and small enterprises and 2.5:1 for Medium enterprises/Service Sector Enterprises.
- Projected DSCR – 2:1, with the extent of relaxation permissible up to 1.5:1.
- Promoter's contribution – 25%, with the extent of relaxation permissible up to 20%.
- Debt ratio for the company (Total debt / Total Asset (capital employed)) – 2:3.
    - Current ratio – 2:1
    - Quick ratio – 1:1
    - Inventory Turnover Ratio – 2 months or 6 times

The analysis is carried out based on audited financials of the latest financial year. The Sanctioning Authority takes a holistic view of the proposal and permits relaxation to the extent permitted as given in the Loan policy document in one or more benchmark norms after considering aspects like risk perception, linkages and benefits accruing to the MSME sector arising out of the Corporation's assistance.

The workflow for sanction and disbursement process followed at KFC is as follows:-

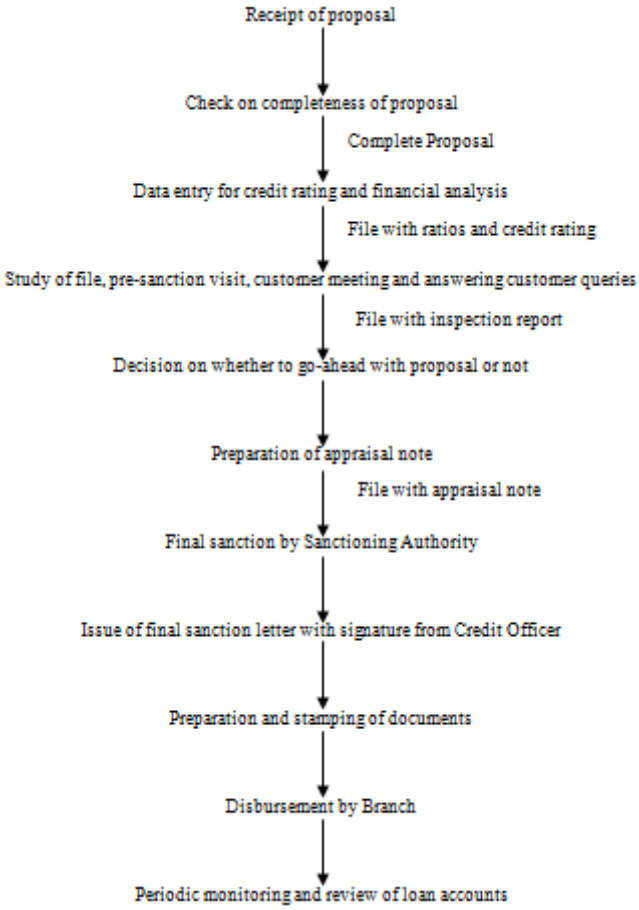

Figure 1: Workflow for Sanction and Disbursement Process at KFC

3.2 Working Capital Revolving Fund Loan To M/s. ABC Wood Industries

A revolving fund is a fund or account that remains available to finance an organization's continuing operations without any fiscal year limitation, because the organization replenishes the fund by repaying money used from the account. This fund is used to provide loans for specified purposes that are repaid to the fund with interest. The income earned from the interest charged for the loans is accumulated in the fund until it is sufficient to pay back the original loan. The loan is returned to the project and can then be used to start another fund somewhere else. Meanwhile the original fund still has capital from the loan repayments and continues to grow as a result of the interest payments.

M/s. ABC Wood Industries is an industrial unit which carries out manufacturing of wooden furniture, seasoning of woods, etc. The loan application was for Rs. 400 lakhs under the Working Capital Revolving Fund Loan scheme for the purpose of expansion of existing unit by stocking wood. The financial appraisal of the proposal showed that the unit's total working capital requirement by the traditional method was Rs. 530 lakhs. The analysis of the financial statements of the latest financial year gave the following results:-

- Debt ratio = 0.04
- Current ratio = 241.51
- Quick ratio = 120.13
- Inventory Turnover Ratio = 1.321 times

The unit was granted a working capital loan of Rs. 360 lakhs.

3.3 Special Working Capital Assistance to M/s. Hotel DEF

M/s. Hotel DEF is a unit which carries out Tourism related activities with attached Bar Hotel. The loan application was for Rs. 50 lakhs under the scheme of Special working capital assistance to hotels for the purpose of renewal of bar license and for meeting short term working capital requirements of the succeeding financial year. The analysis of the financial statements of the latest financial year gave the following results:-

- Debt ratio = 0.223
- Current ratio = 9.27
- Quick ratio = 5.79
- Inventory Turnover Ratio = 14.85 times

The unit was granted a working capital loan of Rs. 50 lakhs.

IV. RESULTS AND DISCUSSION

a. The credit rating is done only once a year at KFC. Therefore, the rating does not take into account short term drastic changes like price level changes (which are an issue with any method based on accounting statements, since annual reports are based on historical cost basis of accounting and other changes like sudden mishap/ of the counterparty are not readily accounted for by the rating system due to long lag between repeat ratings on the same account.

b. The present rating model does not prioritize among the sectors of the economy. The same financial parameters and benchmark values are used to determine the eligibility of a project seeking working capital assistance, irrespective of the sector to which the unit belongs. This is important to be considered since working capital management techniques of firms vary according to the nature of the business carried out.

c. Since manufacturing units are distinguished with their high levels of stock – raw materials, work in progress and finished goods; huge amount of capital to meet their fixed assets' as well as operational requirements; many units follow aggressive strategy of financing with short term loans for financing both short term and long term requirements.

d. Hence, the values of ratios such as current ratio and quick ratio for a manufacturing unit are high as compared to the values of these ratios for a unit functioning under the service sector which is characterized by high inventory turnover ratio and conservative strategy of financing the capital requirements of the firm for both long term as well as working capital needs of the firm.

e. Thus, apart from setting benchmark values for the crucial financial parameters which are assessed, the amount of relaxation which can be allowed in case of units belonging to each sector can be devised accordingly to help in easy assessment and understanding of the relaxation norms to be followed for testing the financial credibility of the applicant firm.

V. CONCLUSION

A banker's philosophy in lending can be summarized in triple components – purpose, repayment ability and structure. First, the purpose of the loan must be legal, ethical and within the bank's policy. Second, the loan can

be repaid from cash flow, collateral and guarantees. Third, the loan can be structured so that is repaid on time, in full and as agreed. Of the trinities, the most important component to the banker is the repayment ability, thereby making it important to evaluate the cash flow from operations, which leads to critical evaluation of the working capital assets and liabilities of the firm (Strischek, 2001) [8].

From the study, it can be concluded that methods used to analyze the eligibility of units seeking loans must be modified to suit the nature of the business the unit caters to, especially while testing the eligibility for granting working capital assistance. This would help in getting consistent results from the operations of the unit funded in the successive years, promising it a bright future which in time would lead to contribution to the progress of the nation.

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